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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

JOSEPH HAMME and R. H. HAMME, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioners, Joseph Hamme and R. H. Hamme, pray that a writ of certiorari be issued to review the decision of the United States Court of Appeals for the Fourth Circuit in the above case.

OPINIONS BELOW

The memorandum findings of fact and opinion of The Tax Court of the United States (R. 4) are reported at 12 T.C.M. 335. The opinion of the United States Court of Appeals for the Fourth Circuit (R. 86) is reported at 209 F. (2d) 29.

JURISDICTION

The judgment of the United States Court of Appeals was entered on December 31, 1953 (R. 94). The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTIONS PRESENTED

In 1944 the petitioners and their wives, each owning an undivided one-fourth interest, conveyed in fee simple approximately 750 acres of land, also all their right, title and interest in a 15-year mineral lease dated August 31, 1942, in consideration of a down payment plus certain percentages of the net selling price to be received by the grantee from the production and sale of tungsten and other minerals. The conveyance was subject to the express condition that said deferred payments, called "royalties," would be paid when due, and in the event of uncured default in such payments, the grantee, its successors and assigns, would by proper deed cause the lands and leaseholds, together with buildings and structures thereon, to be reconveyed to the grantors. During each of the taxable years the petitioners received deferred payments as aforesaid. The questions presented are:

1. Whether the transaction was a sale or a lease.
2. Whether the courts below erred in holding that the payments received were ordinary income in the form of royalties under a lease instead of payments on account of the purchase price.

STATUTE INVOLVED

The pertinent provisions of the Internal Revenue Code are set out in the Appendix hereto.

STATEMENT

The petitioners, brothers, while prospecting in 1942, found tungsten deposits in Vance County, North Carolina.

They and their wives (hereinafter referred to as "the Hammes") pooled their resources and purchased land surrounding the deposits, aggregating 752.1 acres and obtained a 15 year lease on an additional 551.2 acres. By lease dated July 31, 1943, the Hammes leased all of said lands to Haile Gold Mines, Inc. for a period ending April 15, 1944. Said lease included an option whereby the lessee could at any time between March 15 and April 15, 1944, elect to purchase from the landlords all their right, title and interest in and to all mineral, etc. in, under or upon said lands, as well as the mill, machinery, tools and equipment, for ten million dollars, payable principally on the basis of stipulated percentages of the value of the tungsten ore sold or milled each month. The name of Haile Gold Mines, Inc. was changed to Haile Mines, Inc. on September 13, 1943 (R. 5, 6).

The option to purchase was not exercised. Instead, on March 4, 1944, by an "Indenture" the Hammes bargained, sold and conveyed to Haile Mines, Inc., its successors and assigns "in fee simple forever" the same four tracts of land as were then under lease, also all their right, title and interest in and to the said 15 year lease of August 31, 1942. The conveyance was in consideration of the sum of $2,000 "and in consideration also of certain royalty payments and other payments contracted to be made in the future by the party of the second part." The Indenture contains an express condition that the grantee will pay the grantors when justly due the said future payments and in the event of uncured default in that regard, the grantee, on behalf of itself, its successors and assigns, agrees that it will cause to be reconveyed to the grantors, their heirs, assigns and administrators, the "lands and leasehold herein described," and in addition, all the grantee's right, title and interest in 256 acres of adjoining land.[1] (Ex. 4-D, R. 6).

[1] Consisting of the Scott and Sneed tracts which were not conveyed in said Indenture.

An accompanying contract, also dated March 4, 1944, refers to the Indenture as a "deed" as do subsequent conveyances relating to the same lands. (Ex. 5-E, R. 37; Ex. 6-F, R. 43; Ex. 7-G, R. 51; Ex. 8-H, R. 60).

Subsequent actions by the grantee and its assigns leave no doubt that it viewed the transaction of March 4, 1944 as a sale. The identical properties, together with others, were conveyed under date of June 7, 1945 by Haile Mines, Inc. to its subsidiary, Tungsten Mining Corporation (Ex. 6-F, R. 43) which on the same date executed a deed of trust on said properties to secure a loan (Ex. 7-G, R. 51). Furthermore, the grantee specifically referred to the payments in controversy as "part of the purchase price" (Exs. 15, 16, 17, R. 69, 70, 72).

The deferred payments in controversy are measured by the quality and selling price of tungsten ores and concentrates mined and sold by the grantee (and assignee). No limitations are fixed either as to the aggregate of such payments or when they shall cease (Ex. 5-E, R. 37).

During the years 1944 to 1947, inclusive, the Hammes received from Haile Mines, Inc., or its assignee, Tungsten Mining Corporation the following amounts:[2]

1944	$23,995.15
1945	19,132.42
1946	27,217.75
1947	75,129.40

Of the said amount of $23,995.15 for 1944, $5,746.61 was received as royalties under the lease of July 31, 1943. The balance, and all the amounts for 1945, 1946 and 1947, were deferred payments under the Indenture and accompanying contract of March 4, 1944, measured by production and sales of tungsten by the payors (R. 15).

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[2] The Hammes also received $33,609.87 in 1944, and Haile Mines, Inc. assumed their note for $2,268. These amounts are not in dispute.

The respondent held that said deferred payments were royalties received by the petitioners, taxable as ordinary income, and were not payments on account of the purchase price, taxable as capital gains, and determined deficiencies aggregating $13,458.86 for Joseph and $13,689.51 for R. H. Hamme[3] (R. 4).

The Tax Court sustained the respondent's treatment of the payments as royalties in a memorandum opinion by a single judge (R. 4). The Court of Appeals, though conceding that the Hammes and Haile Mines gave evidence that they intended the March 4, 1944 transaction to constitute a sale, affirmed the Tax Court's decision (R. 94).

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals for the Fourth Circuit erred:

1. In holding that the transaction of March 4, 1944 was not a sale and hence the amounts received were not part of the purchase price.

2. In holding that the deferred payments received were royalties, taxable as ordinary income.

3. In affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

I. The Decision of the Court of Appeals is in Conflict With Decisions of This Court.

The Internal Revenue Code, by its silence, accepts the generally understood concept of a "sale." For that reason there have been relatively few occasions for the courts to decide tax cases where the issues directly turned on the status of a transaction as a sale or a lease. There are cases, however, where the status of a transaction was an important if not determining factor in deciding a different,

[3] The Tax Court held that respondent erred in excluding petitioners' wives as equal participants, and reduced the deficiencies. The respondent did not appeal on this point.

though related, issue. Dominant in that group are cases which involved wasting assets such as oil, gas or minerals, and where the primary issue was the right to a depletion deduction. This Court, in those cases, laid down clearly defined principles which, long ago, should have put an end to such litigation. But the respondent still finds it difficult to accept and apply those principles, and in the case at bar the courts below have been similarly affected.

The distinction between a sale and an oil and gas lease was sharply drawn in *Burnet* v. *Harmel*, 287 U.S. 103, in holding (p. 107) that "these leases would not generally be described as a 'sale' of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood". And it refers to mining operations under a lease as in effect a manufacturing business carried on by the use of the soil, "to which the passing of title of the minerals is but an incident rather than a sale of the land or any interest in it or in its mineral content." (p. 107.)[4] In rejecting the suggestion that Congress intended that oil, gas or mineral leases "should be treated like an ordinary sale of land or chattels, resulting in the conversion of capital assets," the opinion in *Burnet* v. *Harmel*, supra, continues (p. 108):

> Such a construction would have disregarded legislative and judicial history of persuasive force; it would have adopted a distorted rather than the common meaning of the term "sale".[5]

At the outset, then, the lower courts, in determining whether the transaction of March 4, 1944 was a "sale", should have accorded the term its "common meaning"

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[4] Citing *Stratton's Independence* v. *Howbert*, 231 U.S. 399, 414, 415; *Von Baumbach* v. *Sargent Land Co.*, 242 U.S. 503, 521.

[5] Citing *Old Colony R. Co.* v. *C.I.R.*, 284 U.S. 552, 561, wherein in rejecting the Commissioner's theory that "interest" meant "effective interest" the Court said "We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term."

"as it is generally understood" to avoid a "distorted" meaning. This they failed to do, even though the Court of Appeals went so far as to say (R. 89):

> We can only agree that the Hammes and Haile Mines gave evidence that from the form and nomenclature of the instrument, they intended this agreement to constitute a sale.

Having apparently agreed that the parties intended a sale, the opinion below injects confusion by reminding us that "the name used by the parties in describing a contract and payments thereunder, do not necessarily determine the tax consequences of their acts" and that "substance and reality" control. We heartily agree with these principles and can only wish the courts below had applied them in the instant case. Had they done so, the manifest intention of the parties to effect a sale would have controlled, and the deferred payments received would have been recognized, in substance, as part of the purchase price rather than, in form, as "royalties".

West v. *Commissioner* (CA-5) 150 F. 2d 723, and *Hogan* v. *Commissioner* (CA-5) 141 F. 2d 92, cited in the opinion below serve only to distinguish the case at bar on the basis of other important principles laid down by this Court, and misapplied here. Both the *West* and *Hogan* cases turned for decision on whether the grantor retained an "economic interest" in the oil and gas in place and in both cases the affirmative answer was based on the express exception and reservation by the grantor of a royalty interest. The Hammes in their conveyance excepted or reserved nothing; they conveyed everything they had—in fee simple as to everything but the 15 year lease, and all right, title and interest as to that. Yet it is said they retained an economic interest, hence the payments received were royalties.

The provision for equitable apportionment of depletion allowances "in the case of leases"[6] resulted in this Court's

[6] Sec. 23 I.R.C. and similar provisions of prior Revenue Acts.

review of many cases involving the right to depletion deductions and related questions: *Palmer* v. *Bender*, 287 U.S. 551; *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312; *Helvering* v. *Bankline Oil Company*, 303 U.S. 362; *Helvering* v. *Thomas A. O'Donnell*, 303 U.S. 370; *Helvering* v. *Elbe Oil Land Development Company*, 303 U.S. 372; *Anderson* v. *Helvering*, 310 U.S. 404; *Kirby Petroleum Co.* v. *C.I.R.*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *C.I.R.*, 328 U.S. 25. Failure of the court below to assimilate and apply the principles therein laid down necessitates this petition.

By virtue of a lease, a lessor retains a right to share in the mineral produced, which constitutes an economic interest in the mineral, in place; and a lessee acquires an economic interest therein. *Palmer* v. *Bender, supra; Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364. When a lessee transfers operating rights under a lease with a stipulation for royalties he retains an economic interest identical with that of a lessor; and the transferee, by whatever name called, acquires an economic interest. *Palmer* v. *Bender, supra; Burton-Sutton Oil Co.* v. *C.I.R., supra.*

The ownership of a capital investment or economic interest in the mineral, in place, entitles the taxpayer to a portion of the gross income received from mining operations—a prerequisite to a depletion deduction. *Helvering* v. *Thomas O'Donnell, supra,* at pp. 371-372; *Thomas* v. *Perkins,* 301 U.S. 655, 661; *Helvering* v. *Elbe Oil Land Development Company, supra,* at pp. 375-376.

The Circuit Court quotes from *Palmer* v. *Bender, supra,* at p. 557 (R. 91) and by its emphasis on a portion of the excerpt, namely *"by any form of legal relationship"* manifests an erroneous concept of an "economic interest". Under that concept, any person who receives payments which are measured by the production and sale of a depletable product, would have an economic interest entitling him to depletion. This erroneous concept is borne

out by its quotation from *Kirby Petroleum Co.* v. *C.I.R., supra,* which immediately follows in the Circuit Court's opinion (R. 91), and from its later statement (R. 93) that the petitioners "must have retained as much 'capital investment' or economic interest as an intermediate assignor of a lease was held to have retained in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25." Even more revealing is the earlier language[7] (R. 91) that "where one who previously had an economic interest in the minerals makes a transfer—'a right to share in net profits is . . . an economic interest . . . '."

If, as appears, the court below draws no distinction between (a) a transfer *under a lease* with the reservation of a royalty and (b) a sale of all right, title and interest, and if, as appears, its decision is based on the proposition that, regardless of the form of legal relationship, a right to share in net profits is an economic interest, there has been an egregious misunderstanding and misapplication of the authorities.

"By an outright sale of his interest . . . an owner converts the form of his investment, severs his connection with the production . . . and the income derived from production," *Anderson* v. *Helvering,* 310 U.S. 404, 408; cf. *Helvering* v. *Elbe Oil Land Development Company,* 303 U.S. 372. Clarifying certain language in *Anderson* v. *Helvering, supra,* the opinion in *Kirby Petroleum Co.* v. *C.I.R.,* 326 U.S. 599, 606, states:

> Thus the Anderson Case correctly stated that a share in "net profits," *disassociated from an economic interest,* does not entitle the holder to a depletion allowance. The facts of each transaction must be appraised to determine whether the transferor has made an absolute sale or has retained an economic interest—a capital investment. (Emphasis supplied)

[7] Referring to the *Burton-Suton* case, and quoting from Appleman, *Taxation of Sales and Assignments of Leases and Other Interests in Oil and Gas,* 28 Texas L. Rev. 340, 358 (1950).

Thus, this Court has left no doubt that a share in net profits pursuant to the retention of an economic interest under a lease is treated as royalty income, subject to a depletion allowance, but a share in net profits as part consideration for a sale is entirely different. The seller disposes of his economic interest, hence the payments received (even though measured by the net profits of the purchaser) are part of the purchase price and are not subject to depletion.

The lower court's attempt to distinguish the case at bar from decisions of this Court unduly stresses factual differences and ignores principles. It points to the large initial payment in the *Elbe* case, *supra*, ignoring the fact that there was an infinitely larger initial payment in the *Palmer* case, *supra*, which did not alter the principle that it is the nature of the transaction which determines the character of the payment. It summarily dismisses *Helvering* v. *O'Donnell*, 303 U.S. 370 and *Burnet* v. *Logan*, 283 U.S. 404, as having no bearing because of factual differences, again ignoring the principle that the nature of the transaction as a sale is unaffected by the fact that the payments received are measured by future sales of depletable products in a presently unascertainable aggregate amount.

The Circuit Court points to the "condition" in the instrument of March 4, 1944, which requires the grantee to make the deferred payments justly due, and obligates it, in the event of uncured default, to reconvey the lands and leasehold, together with the buildings and structures thereon.[8] It reaches the novel and unsupportable conclusion that by reason of this "condition" there is a "certainty of a reverter in this 'sale' ".[9] (R. 93) But

[8] The provision for abandonment of the purchase, and the reconveyance of the properties in the *Elbe* case, *supra*, did not militate against the sale.

[9] This conclusion will be discussed in the second reason for granting the writ, *infra*, pp. 12-14.

in the next breath it recognizes its position as tenuous by its qualified agreement with the Tax Court that the provisions of the March 4, 1944 instruments "weigh heavily in favor of a leasing arrangement."

II. An Important Question Is Involved Herein Which Can Be Settled Only by This Court.

A question of far reaching importance in the administration of the federal income tax laws is raised by this case. The Internal Revenue Code does not define a "sale" thereby implying that the term should be accorded its plain, everyday meaning.[10] The necessity for uniform application of the revenue laws on a nation wide basis precludes the application of purely local laws which are contrary to the general law.[11] It follows that a transaction which would qualify as a sale under general law should be treated as a sale for tax purposes. But the respondent does not agree, and has persuaded both of the lower courts that different criteria apply in the case at bar.

Both the Tax Court and the Circuit Court attempted to distinguish the *Elbe* case, *supra*, on the basis of the size of the down payment. But under general law neither the size of the down payment nor the terms of payment of the balance of the selling price have any effect on the status as a sale.

The Tax Court suggested another distinction between this and the *Elbe* case, namely, that in the latter "the parties emphatically stated that the grantor retained no interest whatsoever in the property transferred" (R. 11). While the Tax Court implied that in this case there was no such intention manifested, the Court of Appeals appears to agree with petitioners that the parties to the trans-

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[10] *Burnet* v. *Harmel*, 287 U.S. 103, 107. Cf. *Old Colony R. Co.* v. *C.I.R.*, 284 U.S. 552, 561.

[11] *Burnet* v. *Harmel, supra; Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U.S. 308.

action intended a sale,[12] though its language is somewhat ambiguous. The opinion says (R. 89):

> Petitioners contend that the specific language of the alleged indenture establishes it as a true deed and that, if there be any ambiguity discernible in this instrument, the subsequent acts of the parties inescapably confirm the intention of the parties that the agreement of March 4, 1944, constituted a sale. We can only agree that the Hammes and Haile Mines gave evidence that from the form and nomenclature of the instrument, they intended this agreement to constitute a sale.

Where the intention of the parties was to effect a sale, under general law such intention would be controlling, assuming the other elements to be present, but here the court below brushes such intention aside. Granting that for tax purposes, substance and reality control,[13] it is a gross misapplication of that principle to say that it compels an utter disregard of the parties' intention. It is in direct conflict with *Thomas* v. *Perkins*, 301 U.S. 655, 659.

Other reasons assigned for affirming the Tax Court evidence further unwarranted departures from the general law. The Circuit Court spells out the reservation in the Hammes of a reversionary interest, in the following language (R. 93):

> The two instruments of March 4, 1944, must be read and construed together to determine their substance and practical effect. In this regard, it is interesting to note that the contract of payment never comes to an end, and, since the mineral supply is not absolutely inexhaustible, then there is a certainty of a reverter in this "sale."

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[12] Any doubt in that regard is removed by the later acts and writings of the grantee (Exs. 6-F, R. 43; 7-G, R. 51; 8-H, R. 60; 15-17, R. 68-74, inc.). *Thomas* v. *Perkins*, 301 U.S. 655, 659.

[13] *Helvering* v. *Lazarus & Co.*, 308 U.S. 252.

This reasoning undoubtedly stems from the conclusion that, inevitably, the land, buildings and structures must be returned to the Hammes—a result which takes no cognizance of the legal barriers thereto.

To begin with, the "condition" in the Indenture, is that the grantee will pay, when due, the deferred amounts "justly due to be paid". To become operative, then, there must first be a default in payment. Unless and until there is a default, the Hammes have no vestige of right, title or interest in the land and improvements, and no right or control with respect to the mining operations carried on by the grantee or its assigns. In the event of an uncured default, the grantee "shall by proper deed" cause the lands and leasehold "to be reconveyed" to the Hammes. If the Hammes had retained a reversion, *no reconveyance* "by proper deed" would have been required. But the gravamen of the lower court's error lies in failing to consider what legal difficulties must be surmounted before any such reconveyance could take place.

The deed of trust of Tungsten Mining Co. executed June 7, 1945 (Ex. 7-G, R. 51) refers to an investment of $300,000 by General Electric Co., a major portion of which, at least, was presumably for capital improvements. On April 15, 1947, Haile Mines, Inc. notified the Hammes that an additional $500,000 was to be invested in capital improvements (Ex. 15, R. 69). A reconveyance, therefore, would entail the return to the Hammes of the original lands which were conveyed in fee (approximately 750 acres), plus what remained of the leasehold which they assigned, plus capital improvements placed thereon by Haile Mines or its subsidiary at a cost of at least $800,000, to say nothing of the additional lands (not previously owned or leased by the Hammes) referred to in the Indenture.

In light of these facts and circumstances it is unthinkable that at the time the commercially recoverable minerals have been mined and sold, the Hammes would

assert, or the grantee or its assignee would agree, that the failure to make further payments to the Hammes would constitute a default and that the lands and improvements must be reconveyed. And the difficulties which the Hammes would face if they sought the aid of a court of equity to compel such reconveyance are too apparent to require elaboration. So when the court below holds that there is a "certainty of a reverter" as the basis for concluding that there was no sale, it does violence to basic legal principles.

To construe the "condition" as has the Circuit Court violates the fundamental rule that a condition may be excused if it involves extreme forfeiture or penalty, as against public policy. *Restate. Law of Contracts,* Sec. 302. Where there are doubts "whether a clause be a covenant or condition, the courts will incline against the latter construction; indeed, always construe clauses in deeds as covenants rather than as conditions, if it is possible to do so." *Oregon & C.R. Co.* v. *United States,* 238 U.S. 393, 420; *Columbia Railway, Gas & E. Co.* v. *South Carolina,* 261 U.S. 236, 249.[14]

The deferred payments in the case at bar are in the same category as those in *Helvering* v. *O'Donnell, supra,* and *Helvering* v. *Elbe Oil Land Development Company,* 303 U.S. 372; they were made pursuant to the personal covenants of the grantee and its assignee.

In drawing unwarranted distinctions between the general law and the tax laws as to what constitutes a sale and the erroneous construction of documents in connection therewith, the Court of Appeals has raised doubts which can only be resolved by this Court.

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[14] The North Carolina authorities hold to the same effect: *Hinton* v. *Vinson,* 180 N.C. 393, 104 S.E. 897 (1920); *Huntley* v. *McBrayer,* 172 N.C. 642, 90 S.E. 754 (1916).

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

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APPENDIX

Statute and Regulations Involved

The pertinent provisions of the Internal Revenue Code are:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions: * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

Sec. 114. Basis For Depreciation And Depletion. * * *

(b) Basis For Depletion.—* * *

(4) Percentage Depletion For Coal, Bauxite, Fluorspar, Flake Graphite, Vermiculite, Beryl, Feldspar, Mica, Talc (Including Pyrophyllite), Lepidolite, Spodumene, Barite, Ball, Sagger, And China Clay, Rock Asphalt, Phosphate Rock, Trona, Bentonite, Gilsonite, Thenardite, And Metal Mines, Potash, and Sulfur.—

(A) In General.—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc (including pyrophyllite) lepidolite, spodumene, barite, ball, sagger, and china clay, phosphate rock, rock asphalt mines, trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine), and potash mines or deposits, 15 per centum, and in the case of sulfur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(B) Definition of Gross Income From Property.—As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining", as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners of or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking sizing, and loading for shipment; (ii) in the case of sulphur-pumping to vats, cooling, breaking, and

loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; and (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 731 and 735.

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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 646

JOSEPH HAMME AND R. H. HAMME, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 4-12) are not officially reported. The opinion of the Court of Appeals (R. 86-94) is reported at 209 F. 2d 29.

JURISDICTION

The judgment of the Court of Appeals was entered on December 31, 1953. (R. 94.) The petition for a writ of certiorari was filed on March 17, 1954. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether payments made to the taxpayers by a mining company were royalties taxable as ordinary

income under Section 22(a) of the Internal Revenue Code or payments on the purchase of real and personal property taxable as capital gains under Section 117 of the Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent provision of the Internal Revenue Code and of the Regulations thereunder are printed in the Appendix, *infra*.

STATEMENT

The facts as stipulated by the parties (R. 14-16) and as found by the Tax Court (R. 4-9) may be summarized as follows:

Prior to March 4, 1944, the taxpayers, together with their respective wives [1], were the owners and lessees of tracts of land containing tungsten deposits in Vance County, North Carolina. (R. 4-6.)

On March 4, 1944, the taxpayers and Haile Mines, Inc. (hereinafter referred to as Haile), executed two instruments called an "Indenture" (R. 6, 30-37) and a "Contract" (R. 7, 37-42). The indenture provided that, in consideration of the payment of $2,000 in cash and of "royalty payments and other payments contracted to be made in the future", the taxpayers "bargained and sold" to Haile the land and equipment thereon "in fee

[1] The Tax Court held that the income was taxable one-half to the wives and one-half to the taxpayers. (R. 12.) There was no appeal on this point. For convenience, no further reference to the interests of the wives will be made in this brief.

simple forever." (R. 6, 31-32, 33.) The indenture also provided that in case of default in paying the "royalties" due as specified in the accompanying contract, Haile would reconvey the properties to the taxpayers, together with all its rights in certain other adjoining land. (R. 6, 33-34.)

The contract provided for the payment by Haile to the taxpayers of "royalties on ores, minerals, concentrates or any mineral products derived and sold from the lands" at various percentages of the net sales, depending upon the mineral content of the ores or concentrates. (R. 7, 38.) The royalties were to be paid at a minimum rate of $10,000 every six months but the payments were to be cumulative so that any excess over $10,000 during a period of six months would be carried forward and applied to a deficiency in any subsequent period. (R. 7-8, 37-42.) The contract also provided for the payment of "royalties" to the taxpayers on minerals extracted by Haile from any properties within ten miles which might be acquired in the future by either party. (R. 7-8, 39-40.)

Income tax returns for the years involved were filed by the taxpayers reporting the royalty payments from Haile (or its assignee, Tungsten Mining Corporation) pursuant to the contract as ordinary income. Subsequently, amended returns were filed in which one-half of the amounts received from Haile were reported as long-term capital

gains from the sale of real and personal property. (R. 8, 16.)

In determining deficiencies, the Commissioner reduced the taxpayers' receipts under the Haile contract by 15% to represent depletion, and taxed the entire remainder as ordinary income. (R. 8.)

The Tax Court held that the taxpayers had retained an economic interest in the mineral deposits covered by the March 4, 1944, indenture and contract, and that the share of each taxpayer was taxable as ordinary income rather than as payments realized from the sale of capital assets. (R. 9-12.) The Court of Appeals affirmed the decision of the Tax Court. (R. 86-94.)

ARGUMENT

This case involves the question of whether the taxpayers retained, by their transaction with Haile, an economic interest in the mineral properties involved. The Tax Court analyzed the facts and concluded that such an economic interest had been retained. The Court of Appeals affirmed. The decision below is correct and further review by this Court is not warranted. It was a correct application of the rule set forth by this Court in *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, 606, that the facts of each transaction must be appraised to determine whether the transferor has made an absolute sale or has retained an economic interest in the minerals. Both the Tax Court and the Court

of Appeals concluded that the aspects of the transaction which indicated a retention of an economic interest by the taxpayers outweighed the factors of the transaction which tended to show it to be an absolute conveyance or sale. (R. 8-9, 93.)

In finding that the taxpayers had retained an economic interest, the courts below relied principally upon the fact that the payments made by Haile, designated as "royalties" by the parties (R. 7, 11), were dependent upon the production of minerals from the land (R. 10, 92) and from the fact that the taxpayers were entitled to possession of the land after the minerals had been exhausted, by reason of the provisions in the indenture for reconveyance upon default by Haile in making payments. (R. 12, 93).

Under the decisions of this Court these factors alone were sufficient upon which to base the determination of the lower courts that the taxpayers had retained an economic interest in the minerals and that the payments derived therefrom should be taxed to them as ordinary income. In *Palmer* v. *Bender*, 287 U. S. 551, and *Burnet* v. *Harmel*, 287 U. S. 103, it was settled that the retention of the right to participate in receipts from the production of minerals was an economic inerest, and, more recently, in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, this Court has held that the retention of a right to share the net profits derived from the production of minerals, although un-

accompanied by a royalty or any other economic interest, is an economic interest in its own right. In accord, see *Kirby Petroleum Co.* v. *Commissioner, supra.*

The taxpayers contend that the courts below erred in not finding from the evidence that the transaction was actually a sale instead of a lease. In finding that the taxpayer retained an economic interest in the minerals, the courts, however, were not required, as contended by the taxpayers, to be bound by the stated intent of the parties and the technical form in which the transaction was cast. *Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 35; *Palmer* v. *Bender, supra,* p. 556.

In this case there was no such evidence of the severing of the taxpayers' connection with the production of minerals as existed in the cases relied upon by the taxpayers. (Br. 9.) *Anderson* v. *Helvering,* 310 U. S. 404; *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372. The unique facts in those cases, which required a determination that the transactions involved therein had been outright sales, have been discussed by this Court in *Kirby Petroleum Co.* v. *Commissioner, supra,* pp. 605-606, and *Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 36, respectively. In the *Anderson* case the deferred payments on a definite purchase price were to be made from sources other than the production of minerals and were not to continue indefinitely, as in this case, until the minerals were exhausted. In

the *Elbe Oil Land Co.* case a large initial payment, in excess of the cost of the properties, and certain deferred payments were payable absolutely and there was a specific provision that the making of such payments would result in full ownership irrespective of the other provisions for sharing in the net profits of the enterprise. Here the taxpayers' only chance of profit lay in future production of the minerals and the properties were to be returned to the taxpayers in the event production ceased and there was a default. (R. 11-12.)

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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APRIL, 1954.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the

Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(n) *Basis for Depreciation and Depletion.*— The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

(26 U.S.C. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(4) [As amended by Sec. 145 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, and Sec. 124 (a) and (c), Revenue Act of 1943, c. 63, 58 Stat. 21] *Percentage depletion for coal* * * * *and metal mines* * * *.—

(A) *In General.*—The allowance for depletion under section 23 (m) shall be, in the case of * * * metal mines * * * 15 per centum * * * of the

gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(B) *Definition of Gross Income From Property.*—As used in this paragraph the term "gross income from the property" means the gross income from mining. * * *

(26 U.S.C. 114.)

SEC. 117 [As amended by Sec. 150 (a) (1), Revenue Act of 1942, *supra*]. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain

is taken into account in computing net income;

* * * * *

(26 U.S.C. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.*— Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an

agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." * * *

* * * * *

(i) "The property," as used in section 114 (b) (2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. * * *

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